

The Effects of Corporate Governance on Company Performance: Evidence from Sri Lankan Financial Services Industry

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Abstract

Main purpose of the study is to identify the relationship between corporate governance and company performance of financial service industry of Sri Lanka from financial year 2008-2011. There were 33 banks, finance and insurance organizations listed in the CSE as at 1st April 2007. 20 of these organizations have been selected randomly as the sample of the study. The governance variables and performance variables are tested under Simple Linear Regression model to identify any relationships. The three variables related to Corporate Governance are included in this study (Board size, board composition and Audit Committee) while performance of the firms is measured by return on assets (ROA) and return on equity (ROE). The study however could not provide a significant relationship between the two performance measures and corporate governance. These results are consistent with prior empirical study.

Keywords: Corporate Governance, company performance, financial service industry, Sri Lanka.

Introduction

Corporate governance has become a popular discussion topic in developed and developing countries. The widely held view that corporate governance determines firm performance and protects the interests of shareholders has led to increasing global attention. However, the way in which corporate governance is organized differs between countries, depending on the economic, political and social contexts.

Corporate Governance refers to the way an organization is directed, administrated or controlled. It includes the set of rules and regulations that affect the manager's decision and contribute to the way company is perceived by the current and potential stakeholders. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation such as; boards, managers, shareholders and other stakeholders and spells out the rules and procedures and also decision making assistance on corporate affairs. By doing this, it also provides the structure through which the company's objectives are set and the means of obtaining those objectives and monitoring performance. Corporate governance may be the ways of bringing the interests of investors and managers into line and ensuring that firms are run for the benefit of investors.

According to OECD principles corporate governance is a system by which business corporations are directed and controlled. The corporate governance structures specify the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance (OECD 1999).

Internationally there is a growing recognition of the importance of corporate governance for the success of a firm. Several countries have issued guidelines and recommendations for best governance practices. However, whether firms following the best practice recommendations regarding Corporate Governance will indeed perform better is a question to be examined empirically in Sri Lankan context. Sri Lankan listed firms have to follow a set of guidelines with respect to CG practices. Even though these are not binding on firms, compliance is expected at least by firms listed in the stock exchange. Since the sample of the firms chosen for the current study comes from Sri Lanka, it provides opportunity to examine linkage between Corporate Governance and firm performance in Sri Lankan context.

In Sri Lanka, the Financial Services Industry also plays a considerable role in the economic development and business improvement. The Financial Services Industry has become increasingly competitive over the past few decades and many of Financial Services organizations have invested heavily in infrastructure, technology process and agriculture, etc in this country. Therefore the financial performances of the Financial Services Industry are also very important to Financial Services organizations and country.

According to Cadbury (1992), corporate governance is the mechanism used to discipline organizations. Morin and Jarrell (2001) argue that corporate governance mechanism is a framework that controls and safeguards the interest of the relevant players in the market which include managers, employees, customers, shareholders, executive management, suppliers and the board of directors.

LITERATURE REVIEW

Several studies have been conducted so far and still going on to examine the relationship between firm performance and corporate governance mechanisms, but the results are mixed.

It is widely acclaimed that good corporate governance enhances a firm's performance (Brickley et al, 1994; Brickley and James, 1987; Byrd and Hickman, 1992; Chung et al, 2003; Hossain et al, 2000; Lee et al, 1992; Rosenstein and Wyatt, 1990; Weisbach, 1988). In spite of the generally accepted notion that effective corporate governance enhances firm performance, other studies have reported negative relationship between corporate governance and firm performance (Bathala and Rao, 1995; Hutchinson, 2002) or have not found any relationship (Prevost et al. 2002; Young, 2003).

Yermack (1996) examines the relation between board size and firm performance, concluding that the smaller the board sizes the better the performance, and proposing an optimal board size of ten or fewer. John and Senbet (1998) maintain that the findings of Yermack have important implications, not least because they may call for the need to depend on forces outside the market system in order to determine the size of the board.

Hence, as board size increases board activity is expected to increase to compensate for increasing process losses (Vafeas, 1999). The argument is that large boards are less effective and are easier for a CEO to control. The cost of coordination and processing problems is also high in large boards and this makes decision-taking difficult. On the other hand, smaller boards reduce the possibility of free-riding and therefore have the tendency of enhancing firm performance.

Keeping boards small can help improve their performance. When board gets beyond seven or eight people they are less likely to function effectively and are easier for the CEO to control (Jensen 1993). In contrast, research in the area suggests that as groups increase in size, they become less effective because of coordination and process problems outweighing the advantages gained from having people of diverse background (Steiner, 1972).

Empirical evidence regarding the relationship between firm performance and board composition is mixed. Baysinger and Butler (1985) found that firms with higher numbers of outside directors on the board had a greater return on equity than the board with inside directors. Ezzamel and Watson (1993) also found that outside directors were positively associated with profitability among a sample of UK firms. Hermalin and Weisbach (1991) and Bhagat and Black (2002) find no correlation between the degree of board independence and four measures of firm performance, 20 European Journal of Economics, Finance and Administrative Sciences - Issue 14 (2008) controlling for a variety of other governance variables, including ownership characteristics, firm and board size and industry. They find that poorly performing firms were more likely to increase the independence of their board.

The outside directors are in a position to exert an intensive influence on the management because they are independent financially and is of different self interest than the inside directors hence are in a position to protect the interest of the shareholders than the inside directors (Fama, 1980). On the other hand, studies by Klein (1998), Bhagat et al (1997), and Hermalin et al (1991) experienced a high proportion of independent directors does not predict a better future accounting performance.

The Cadbury committee (Cadbury 1992) also recommends that the ideal size of the board should be between eight and ten members and that there had to be one executive director for every non-executive director. Hermalin and Weisbach (1991) find no association between the proportion of outside directors and Tobin's Q and Bhagat and Black (2002) find no linkage between the proportion of outside directors and Tobin's Q, return on assets, asset turnover and stock returns.

Velnampy (2013), analyzing publicly traded SriLankan manufacturing companies find that determinants of corporate governance are not correlated to the performance measures of the organization. Regression model showed that corporate governance don't affect companies' ROE and ROA. This result was supported by Achchuthan that, there is no significant mean different between the firm performance among *corporate governance as board leadership structure*, board committees *practices*, board meetings and proportion of non executive directors.

Zhaoyang Guo and Udaya Kumara Kgab(2012), state that, (i) board size and proportion of non- executive directors in the board shows a marginal negative relationship with firm value, (ii) proportion of non-executive directors in a board and financial performance of firm shows negative relation contrary to the findings of previous studies. The firm size and director shareholdings have a significant impact on firm performance of listed firms in Sri Lanka.

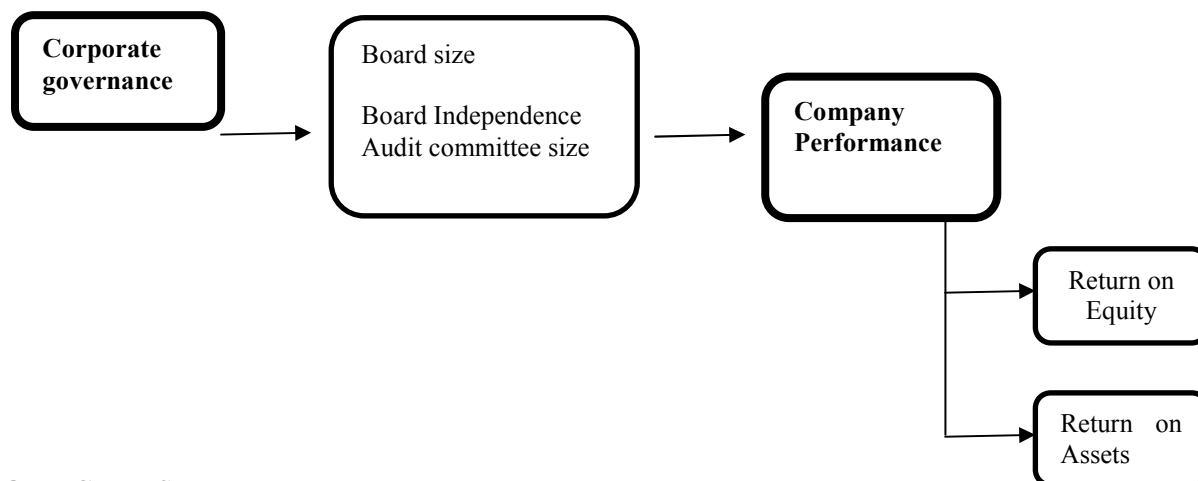
Kumi Heenetigala and Anona Fern Armstrong (2011), Suggest a positive relationship between governance practices (separate leadership, board composition, board committee and firm performance) based on return on equity, and board composition, board committees and performance measured by Tobin's Q. These relationships indicate that firms have implemented corporate governance strategies, which have resulted in higher profitability and share price performance.

The present paper aims to improve the literature on the corporate governance - company performance linkage by

providing an analysis of the Sri Lankan financial service industry for four years (2008-2011) and analyzing board of directors attributes.

RESEARCH MODEL

Based on a review of the relevant literature, this research investigates corporate governance practices and firm performance in a particular business environment. A conceptual framework developed in this section provides a framework to understand the affects of the variables on firm performance, and identifies the hypotheses regarding the relationship of corporate governance variables to firm performance in Sri Lanka.



OBJECTIVES

- Investigate the extent to which the companies have adopted corporate governance practices.
- Determine the relationships between corporate governance practices (such as Board, Audit Committee) on firm performance

HYPOTHESIS

- [1] There is a positive relationship between corporate governance and ROE
- [2] There is a positive relationship between corporate governance and ROA

SAMPLE SELECTION

There were thirty nine banks, finance and insurance organizations listed in the CSE as at 10th January 2010. As per the scope of the study researcher has selected these organizations listed in the CSE as the population. Twenty of these organizations have been selected randomly as the sample of the study.

PERIOD OF THE STUDY

The study examined the data for the years 2008 to 2011. The reason for selection of the years was that the corporate governance guidelines were introduced in 2003. Four years later, 2007, was a suitable time period, in which companies who had adopted the practices could have been expected to show some change in adoption of the practices and if this had had an impact on company performance. Reporting of corporate governance practices was voluntary during this period. The code of corporate governance was mandated in 2007 to be effective for companies reporting on or after the 1st April 2008. Therefore, the year 2007 was an important year to examine the effectiveness of the voluntary code on performance.

DATA COLLECTION

The data and information required for the study were collected from the Colombo Stock Exchange (CSE) websites, annual reports, and the Colombo Stock Exchange publication "The Hand book of listed companies".. Evidence required to test the hypotheses in this study is based on annual reports and published statistics. Therefore data derived for this study is from secondary sources.

METHODS OF DATA ANALYSIS

SPSS (Statistical Package for Social Science) was used to analysis the data to test the hypothesis. The suitable tools were used to test the hypothesis and find the reliability. Following techniques are used to validate the findings and to get best solution. Correlation analysis is used to identify the strength or weakness of relationship between corporate governance practices on firm performance. Regression analysis is used to identify how corporate governance practices effect on firm performance and as well as other factors extends.

VARIABLES DESCRIPTION

Described below are the variables used to operationalise the constructs. They include the corporate governance variables (board size, board composition and audit committees) and company performance.

| Concept | variable | Measurement |
|--------------------------------------|-----------------------------|---|
| Company Performance | Dependent variable | |
| | Return on Equity[ROE] | $\frac{\text{Earnings before interest and tax}}{\text{Total equity shares in issue}}$ |
| | Return on assets [ROA] | $\frac{\text{Earnings before interest and tax}}{\text{Total asset}}$ |
| Corporate Governance Characteristics | Independent variable | |
| | Board size | Number of directors on the board. |
| | Board composition | Proportion of outside directors sitting on the board. |
| | Size of audit committee | Number of members of audit committee |

MODEL

The following conceptual model was formulated through the extensive literature.

$$ROE = \beta_0 + \beta_1 BSIZE + \beta_2 BCOM + \beta_3 ASIZE + \epsilon$$

$$ROA = \beta_0 + \beta_1 BSIZE + \beta_2 BCOM + \beta_3 ASIZE + \epsilon$$

It is important to note that the ROA and ROE depend upon BSIZE, BCOM and AUSIZE.

Whereas:

β =Intercept

ROA = Return on Assets.

ROE= Return on Equity

BSIZE= Board size

BCOM= Board composition

ASIZE= Size of audit committee

ϵ = Standard error of the sample

Empirical Results and Discussion

Descriptive Statistics

Table 1 below shows the descriptive statistics of all the variables used in this study. Descriptive statistics were carried out to obtain sample characteristics.

Table 1: Descriptive statistics for the whole sample

| | Range | Minimum | Maximum | Mean | Std. Deviation |
|----------------------|--------|---------|---------|---------|----------------|
| Board size | 9 | 5 | 14 | 8.83 | 1.999 |
| Board composition | 7 | 3 | 10 | 6.79 | 1.921 |
| Audit committee size | 3 | 2 | 5 | 3.08 | .759 |
| Return on Equity | 6.3747 | -3.6235 | 2.7511 | .136022 | .6839601 |
| Return on Assets | .5866 | -.3875 | .1991 | .019596 | .0881506 |

The above descriptive statistics shows the number of directors in the board have a wide range from 5 to 14. The mean of the size of the board is 8.83, with a standard deviation of 1.999. This is in par with many studies undertaken previously. The Cadbury Committee report (1992) also recommends the size of the board to be between 8 and 10 members. It can be noted from Table 1 that the proportion of the number of non executive directors sitting on the board is about 6.79. This indicates that from the board size approximately 70% of them are non-executive directors. Considering the composition of the audit committee, the number of members floats from 2to 5directors.

Results of Pearson Correlation Analysis

Table 4.2 presents the Pearson correlation coefficients between dependent variables and independent variables to find out the relationship between determinants of corporate governance and the measures of firm performance.

Table 2: Correlation Matrix

| | | Correlations | | | | |
|-------------------|---------------------|--------------|-------------------|-----------------|------------------|------------------|
| | | Board size | Board composition | Audit committee | Return on Equity | Return on Assets |
| Board size | Pearson Correlation | 1 | .762** | .559** | .134 | -.026 |
| | Sig. (2-tailed) | | .000 | .000 | .235 | .816 |
| | N | 80 | 80 | 80 | 80 | 80 |
| Board composition | Pearson Correlation | .762** | 1 | .601** | .105 | .076 |
| | Sig. (2-tailed) | .000 | | .000 | .355 | .502 |
| | N | 80 | 80 | 80 | 80 | 80 |
| Audit committee | Pearson Correlation | .559** | .601** | 1 | .223* | .059 |
| | Sig. (2-tailed) | .000 | .000 | | .047 | .605 |
| | N | 80 | 80 | 80 | 80 | 80 |
| Return on Equity | Pearson Correlation | .134 | .105 | .223* | 1 | .161 |
| | Sig. (2-tailed) | .235 | .355 | .047 | | .154 |
| | N | 80 | 80 | 80 | 80 | 80 |
| Return on Assets | Pearson Correlation | -.026 | .076 | .059 | .161 | 1 |
| | Sig. (2-tailed) | .816 | .502 | .605 | .154 | |
| | N | 80 | 80 | 80 | 80 | 80 |

** . Correlation is significant at the 0.01 level (2-tailed).

* . Correlation is significant at the 0.05 level (2-tailed).

The results of the correlation analysis in table 02 show that the determinants of corporate governance such as board size, board composition are not significantly correlated with ROE and ROA as the measures of firm performance. But there is a significant relationship between Audit committee and ROE at 0.05 levels. But there is no significant relationship between Audit committee and ROA.

Regression Analysis

A simple linear regression was carried out to recognize the impact of corporate governance on firm performance. Table 3 shows the results of the analysis.

Table 3: Model Summary

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|-------|---------|----------|-------------------|----------------------------|
| 1 | .231(a) | .053 | .016 | .6785275 |
| 1 | .157(b) | .025 | -.014 | .0887626 |

a & b Predictors: (Constant), Audit committee size, Board size, Board composition

a. Dependent Variable: Return on Equity

b. Dependent Variable: Return on Assets

The specification of the three variables in the model revealed the ability to predict performance. R2 Value of 0.053 and 0.025 which are in the models denote that 5.3%, and 2.5% of the observed variability in performance can be explained by the differences in both the independent variables namely board size, board composition, and audit committee. But, remaining percentage of variance is attributed to other factors. R2 values indicate that there may be number of variables which can have an impact on performance that need to be studied.

Tables 4a and 4b show the analysis of variance (ANOVA) of the variables. With F- values of 0.638 and 1.423 for ROA and ROE as performance proxies respectively, it clearly shows that there is no relationship between corporate governance and firm performance.

Table 4a: ANOVA- ROA as a dependent variable

| ANOVA | | | | | | |
|-------|------------|----------------|----|-------------|------|-------------------|
| Model | | Sum of Squares | df | Mean Square | F | Sig. |
| 1 | Regression | .015 | 3 | .005 | .638 | .593 ^a |
| | Residual | .599 | 76 | .008 | | |
| | Total | .614 | 79 | | | |

a. Predictors: (Constant), Audit committee size, Board size, Board composition

b. Dependent Variable: Return on Assets

Table4b: ANOVA- ROE as a dependent variable

| ANOVA | | | | | | |
|-------|------------|----------------|----|-------------|-------|-------------------|
| Model | | Sum of Squares | df | Mean Square | F | Sig. |
| 1 | Regression | 1.966 | 3 | .655 | 1.423 | .243 ^a |
| | Residual | 34.990 | 76 | .460 | | |
| | Total | 36.956 | 79 | | | |

a. Predictors: (Constant), Audit committee size, Board size, Board composition

b. Dependent Variable: Return on Equity

Table 5: -Coefficients for predictors of performance

| Model | Unstandardized Coefficients | | | | Standardized | | t | | Sig. | |
|----------------------|-----------------------------|-------|------------|------|--------------|-------|--------|--------|------|------|
| | B | | Std. Error | | Beta | | | | | |
| Dependent Variable | ROE | ROA | ROE | ROA | ROE | ROA | ROE | ROA | ROE | ROA |
| (Constant) | -.517 | .019 | .376 | .049 | | | -1.376 | .390 | .173 | .697 |
| Board size | .025 | -.009 | .060 | .008 | .072 | -.214 | .412 | -1.201 | .681 | .234 |
| Board composition | -.034 | .009 | .065 | .008 | -.094 | .207 | -.518 | 1.117 | .606 | .267 |
| Audit committee size | .215 | .006 | .128 | .017 | .239 | .054 | 1.679 | .375 | .097 | .709 |

The relationship between board size, board composition and audit committee and the two performance measures is not statistically significant. The implication of this is that for the sampled firms, there is no relationship between the firms' financial performances and corporate governance. Further t values for all four variables of corporate governance are insignificant event at 5% level. It means that these variables are not contributing to the performance measures of ROA and ROE. This outcome also has the support of Forsberg (1989), Weisbach (1991), Bhagat and Black (2002) and Velnampy (2013).

Conclusion and Recommendation

The present study analyzes the relationship between corporate governance of financial services industry and their performances. Using correlation and regression, we examine the effects of corporate governance and firm profitability in terms of ROE and ROA. The sample consists of 20 companies for the period 2008-2011. The results of the study provide evidence that the corporate governance measures are not significantly correlated with ROE and ROA as the performance measures. So that hypotheses one and two are rejected. The results suggested that future research should be carried out with a larger sample. Greater flexibility in acceptable governance structures may therefore be necessary if shareholder interests are to be promoted. Hence further research is significantly recommended.

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